

EXHIBIT

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TPA Strategy Report

December 2010

Executive Summary

BCBSAZ is facing rapid changes to the TPA landscape caused in part by Health Care Reform and increased merger and acquisition (M&A) activity in the TPA industry. These environmental changes and a number of others have been analyzed to clarify the new environment, assess the risks, and support formulation of appropriate responses to protect BCBSAZ's market share and reserve levels.

Purpose

The purpose of this report is to provide decision support regarding BCBSAZ's future role in the Third Party Administrator (TPA) industry. Specifically, this report will provide information on the following:

- Section 1 - TPA industry
- Section 2 - Reasons to enter the TPA industry
- Section 3 - Strategies for entering the TPA industry

*...TPA margins are to be made with value-added services such as health management, PBM, and stop loss **not** claims administration...*

Process

The evaluation team obtained information from various sources:

- Third party research firm was hired to conduct interviews with TPAs. The vendor also interviewed consultants, an industry organization (Managed Care Executive Group), an M&A entity (Duff & Phelps), and an IT services company (Global Care)
- Team representatives attended and reported on the Self-Insurance Institute of America Expo
- Conducted a conference call with former CFO of Epoch, a TPA formerly owned by BCBSKC
- Met with Health Plan Services
- Held conference call with Cain Brothers
- Conducted ADOI and internet research

Key Observations

- According to a variety of external sources, the TPA industry will not be negatively impacted by the provisions of HCR and in fact may benefit as it may cause a shift to the self-insured market.
- Consolidation and acquisition will continue as government regulation and competition increase. Smaller TPAs will be pressured to consolidate, but those with defensible niches will survive and may thrive.
- CHS membership of 300,000+ is at risk if a Carrier-based TPA acquires one or more of our connected TPAs as they would likely roll them into their own network. In addition, entering the TPA market ourselves may threaten existing TPA business.
- TPAs have historically found specialized niches as a way to differentiate themselves. This creates a fragmented TPA market where it is unlikely to find multiple niches within one TPA thus buying, building or partnering with one TPA will not gain access to the TPA market universe. Buying one of the largest TPAs in AZ will only achieve 10-15% market share.
- TPA pricing \$10 - \$15 PCPM for base services. While our fully loaded back-end direct services run around \$30 PCPM, a high level analysis shows that we would only shed between \$6-\$10 PCPM. This makes the strategy to out-source these functions to a TPA less attractive.
- TPA business is a low margin business. Traditional functions such as claims and enrollment administration will generate very little profit, or may become loss leaders. TPA success and profitability will require national networks and nimble technology (HIPAA 5010/ICD-10). Margins will be made with value-added services such as health management, PBM, and stop loss.